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C O N F I D E N T I A L SECTION 01 OF 02 ISLAMABAD 000440

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TAGS: ECON PREL EINV EFIN PK
SUBJECT: KARACHI STOCK EXCHANGE PREPARING IPO; DIRECTORS INSIGHT ON ECONOMIC SITUATION

REF: (A) Islamabad 228 (B) Islamabad 288

Classified By: Ambassador Anne W. Patterson, Reasons 1.4 (b), (d)

¶1. (C) SUMMARY: The Karachi Stock Exchange (KSE) is preparing an initial public offering (IPO) for later this year, provided the GOP implementing legislation is signed by President Musharraf. Following the IPO, only 20 percent of the shares will be owned by members, with 40 percent owned by strategic investors and 40 percent in public hands. While both the Chairman and Managing Director highlighted that 2007 was a good year for both Pakistani businesses and the KSE, they were concerned that the February 18 elections be conducted fairly and not result in violence. They were also watching how the GOP handles the current account and fiscal deficits, and whether the State Bank of Pakistan can maintain its autonomy. End summary.

Karachi Stock Exchange to undergo IPO in 2008

¶2. (C) Econ Counselor and Econoff met with Shaukat Tarin, Chairman, and Adnan Afridi, Managing Director, of the Karachi Stock Exchange in Karachi January 24. Tarin and Afridi explained the initial public offering (IPO) process to Econoffs. Under the new ordinance, which has been passed by the caretaker government cabinet but not yet signed by President Musharraf, Pakistan's three stock exchanges (Karachi, Lahore, and Islamabad) will be for-profit entities, rather than non-profits run by the member-brokers. Once the President signs the ordinance, the KSE will have a 100 day window to begin the IPO process. Deutsche Bank is handling the IPO process.

¶3. (C) Currently the KSE is owned by 200 members, with each seat worth approximately $2 million. According to Afridi, the KSE is currently the second best performing stock market in the world, with average annual growth of 50 percent. Once the IPO is completed, the KSE will be one of only 20 exchanges worldwide to be at least partially publicly owned. As stipulated in the draft ordinance, 20 percent of the shares will remain with the current 200 members, and the remaining 80 percent will be divided between one or more strategic investors (40 percent) and the public (40 percent). Afridi mentioned that the London, New York, Toronto, Dubai and EURONEXT exchanges had already expressed interest. Both Tarin, who handled the recent Saudi-Pak Bank buyout, and Afridi also believe that major investment banks may be interested as well.

¶4. (C) Afridi also explained the benefits of the IPO, or as it is known here, "demutualization." Increasing the ownership base will increase market confidence and dilute the influence of members, leading to greater transparency. Currently there is a conflict of interest inherent in the ability of members to approve regulations

governing their trading. (Comment: Decreased member influence and increased transparency would be a positive development, since one of the KSE's blackest days was caused by persistent rumors of a coup against President Musharraf and that he was under house arrest the day after imposition of the November 3 State of Emergency. End comment.) Afridi commented that presence of one or several strategic investors will increase the KSE's credibility and market efficiency; allow greater access to technology, capital, and trained personnel; and facilitation of mergers and acquisitions due to the increased capital and presence of strategic investors. He also mentioned problems attracting Western-educated Pakistanis to come to work on the stock exchange; they are unwilling to stay or return to Pakistan given the current uncertain economic and political situation.

Pakistan's economic outlook: worrisome

¶5. (C) While commenting that 2007 was a good year for many, if not most, Pakistani companies, both Tarin and Afridi characterized the outlook for 2008 "worrisome." Echoing the views of many other Karachi businessmen (septel), Tarin commented that "the next three to six months will be critical." He is hoping for a smooth political transition, along the lines of what happens in India, so that green field investment will once again flow into Pakistan. Referring to the violence following Bhutto's December 27 assassination (ref A), law and order issues and travel warnings by Western countries have made attracting investment, particularly green field investment, more difficult.

¶6. (C) Tarin highlighted that Pakistan needs $1 billion a month in foreign inflows to sustain economic growth at the current 7 percent rate. He was confident that remittances would continue to flow in at the current rate, and highlighted that some Japanese firms that he

could not specify are interested in using Pakistan as a regional manufacturing export platform. However, neither Tarin nor Afridi were confident that Pakistan could generate this magnitude of inward investment flows for the rest of the fiscal year ending June 30, particularly given the uncertainty surrounding elections and formation of a new government. In response to Econ Counselor's question, Tarin does not believe that China will be a major investor but was concerned about Pakistan's growing trade deficit with China. Pointing to the importance of political stability, he told Econoffs that if the Saudi-Pak bank buyout had not been finalized prior to Bhutto's assassination, he believes that the Bank of Muscat, one of the principle investors, would have delayed the transaction until after the elections.

¶7. (C) Econ Counselor asked about the effects of recent events on the KSE and capital flight. Afridi responded that Western hedge funds, which typically keep their money in the KSE for 4-6 months, have all left, but in an orderly manner. The institutional investors are still in the market, in large part, Afridi commented, to the KSE's low prices and high profits compared to other emerging country stock exchanges. Since November 2007, $400 million has left the market, of which 40-50 percent is short term money. By comparison, KSE received $1 billion in short flows in 2007.

¶8. (C) In response to Econ Counselor's question, both Tarin and Afridi find Pakistan's increasing current account and fiscal deficits a problem. They highlighted that Pakistan is unlikely to increase its exports significantly in the near future, and are not actively seeking to increase regional trade beyond the current five percent. Increased trade with India would provide a good market for many Pakistani textiles as well as cement. (Comment: Cement exports to India began in 2007, and have done extremely well. End comment.)

Comment

¶9. (C) Despite its recent ups and downs, the Karachi Stock Exchange remains one of the Pakistan economy's bright spots. While its listings are still relatively limited, the upcoming IPO may provide a broader base. Tarin and Afridi's comments on Pakistan's current economic situation are consistent with what we heard elsewhere in

Karachi. End comment.

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